NOVA SCOTIA
Finance
Office of the Minister

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Ms. Maureen MacDonald, Chair
Public Accounts Committee
Legislative Committees Office
Dennis Building
1740 Granville St.
Halifax, NS

Dear Ms. MacDonald:

Enclosed is the Auditor General's report to management as a result of the audit of the Province's March 31, 2005 consolidated financial statements and the Department of Finance's reply to the Auditor General. I would ask that you make copies available to each of the members of the Public Accounts Committee.

Sincerely yours,

Peter Christie
Minister

Consolidated Financial Statement Audit

March 31, 2005

Report to Management and Those Having Oversight Responsibility for Financial Reporting

NOVA SCOTIA

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Auditor General

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November 2, 2005

Honourable Peter Christie
Minister of Finance
Department of Finance
Province of Nova Scotia
7th Floor, Provincial Building
Halifax, Nova Scotia

Dear Sir:

Re: Audit of March 31, 2005 Consolidated Financial Statements

Under Section 9 of the Auditor General Act, I am mandated to audit and report on the annual financial statements of the Province. The purpose of this letter is to report relevant findings arising from the audit of the consolidated financial statements (CFSs) of the Province of Nova Scotia for the year ended March 31, 2005.

Based upon the audit procedures completed, it was concluded that the March 31, 2005 consolidated financial statements, which are the responsibility of the Government of Nova Scotia, present fairly, in all material respects, the financial position of the Province as at March 31, 2005 and the results of its operations, changes in net direct debt and cash flows for the year then ended in accordance with Canadian generally accepted accounting principles (GAAP) for the public sector.

The reporting requirements of the Canadian Institute of Chartered Accountants (CICA) assurance standards were considered when determining what information should be included in or with this letter. This letter and attachments are being provided solely for the information of government management and those having oversight responsibility for the financial reporting process and is not intended for any other purpose. The management responses included in this letter have been reproduced verbatim as provided to my Office. Their inclusion in this reporting does not signify agreement with these responses. This letter may be referred to in other audits or reporting by my Office.

The responsibilities of Government and my Office concerning the Province's consolidated financial statements, along with the audit approach used, have already been discussed in Chapter 2 of the June 2005 Report of the Auditor General (see paragraphs 2.17 to 2.29 of that report).

Canadian generally accepted auditing standards require that we communicate annually with those having oversight responsibility for the government's financial reporting process. Part of this communication concerns the independence of my Office from government. The Office of the Auditor General's 2004 Performance Report and 2005 Business Plan publication (issued March 8, 2005) include comments in this regard as well as on the professional conduct rules and standards adhered to by the Office. As of the date of this letter, the Auditor General and the Office are independent of the government.

Matters to Be Reported

Significant accounting policies – As indicated in Note 1 to the March 31, 2005 consolidated financial statements, for purposes of the Province's statements, Canadian GAAP for the public sector is represented by the accounting recommendations of the Public Sector Accounting Board (PSAB) of the CICA, supplemented where appropriate by other CICA and International Federation of Accountants accounting standards or pronouncements. Since GAAP can include recommendations other than those of PSAB, it is important to document other accounting standards or pronouncements used by government in developing the CFSs and thus define what GAAP is for the Province. This could be communicated through the government management manuals.

We recommend GAAP for the Province be clearly defined and communicated.

Management's Response:
As defined in the CICA Handbook for the Public Sector, "generally accepted accounting principles (GAAP) encompass broad principles and conventions of general application as well as rules and procedures that determine accepted accounting practices at a particular time". Because these principles are not intended to remain static, the Handbook clearly refers to GAAP "at a particular time". The Handbook further recommends that a public sector reporting entity should adopt accounting policies and disclosures that are consistent with the primary sources of GAAP. Each year a detailed checklist outlining compliance with each recommendation of the Public Sector Accounting Board (PSAB) is completed (PSAB Checklist) and submitted to the OAG for review as part of the year-end audit process. In addition, an outline of the sources of GAAP detailing specific accounting standards (PSAB, CICA, International, and Other) by financial statement line item was provided to the OAG for review as part of the year-end audit process. All of these items, coupled with the current disclosure in the Public Accounts should clearly communicate our sources of GAAP. To provide more clarification, the Department of Finance will explore adding some information about the sources of GAAP for the Province, essentially the recommendations of PSAB in its GAAP Hierarchy section to the Provincial Management Manuals. It is a matter of public policy that the Province of Nova Scotia adheres to recommendations and pronouncements compliant with GAAP and recommendations that are GAAP compliant are incorporated into the decision making process. This is evidenced by the receipt of an unqualified audit opinion.

Canadian GAAP for the public sector is being followed to the extent necessary to provide an unqualified opinion; however, there are some specific requirements which are not fully met. For example, the following are some identified areas where government should consider fuller GAAP compliance in the future.

- The CFSs do not include PSAB required disclosure of the budget amounts for the line items on the Statement of Operations and Statement of Change in Net Direct Debt. Related to this, the government does not yet prepare or present its budget on a basis fully consistent with that used for the consolidated financial statements. Information is included in the Financial Statement

Discussion and Analysis (FSDA) section of Volume I of the Public Accounts in order to compensate for this lack of disclosure in the statements themselves.

Management's Response:
A group has been formed to review the usefulness and format of the 3 volumes of Public Accounts documents. One area for discussion is the presentation of budget versus actual results. As part of the research for this project, other provinces will be contacted with enquiries on how they prepare budget figures for presentation on the financial statements. Those options will be evaluated and revised disclosures will be assessed for the 2005-06 Public Accounts.

- PSAB requires that expenses be disclosed at gross value. However, there are various user fees, chargeables, and recoveries which are netted against expenses on the Consolidated Statement of Operations. Note 9 to the financial statements provides some disclosure on the amounts netted against expenses but does not provide a break down of gross expenses by line item on the Statement of Operations. Related to this, there is $417.3 million in "less chargeables" to other divisions and departments disclosed in note 9 which represents inter-entity transactions, and therefore should be eliminated. This does not impact on the provincial surplus balance. However, it does result in an overstatement of gross expenses and less chargeables disclosed in note 9. We were informed that expenses are disclosed on a net basis to be consistent with the budget which is presented on a net basis.

  Management's Response:
  In the past, it has been the position of management that the practice of netting expenses is more appropriate from a control perspective, as it increases accountability by Departments over their "net" bottom line. This approach follows the structure of the Estimates in which departmental costs "net" of Recoveries, Fees and Charges, and Chargeable to Other Departments are the basis of the appropriation votes.

  A group has been formed to review the usefulness and format of the Estimates book. One area for discussion is the presentation of expenses on a gross basis, moving the fees and recoveries to the revenue section. As part of the research for this project, other provinces will be contacted with enquiries on how they prepare, vote and monitor their budget figures. The key users of the Estimates will also be consulted. Those options will be evaluated and revised disclosures will be assessed for implementation.

- There are some federal transfer payment revenues which are being recorded as recoveries and netted against expenses. We identified $14.3 million in federal grant payments which were recorded as recoveries. Staff of the department indicated that there was an additional $147.3 million in federal payments recorded as recoveries. The impact of this accounting treatment is an understatement of revenues and expenses with no impact on the surplus balance. We were informed that these revenues are treated as recoveries to be consistent with their treatment in the budget.

Management's Response:
In the past, it has been the position of management that the practice of netting expenses is more appropriate from a control perspective, as it increases accountability by Departments over their "net" bottom line. This approach follows the structure of the Estimates in which departmental costs "net" of Recoveries, Fees and Charges, and Chargeable to Other Departments are the basis of the appropriation votes.

A group has been formed to review the usefulness and format of the Estimates book. One area for discussion is the presentation of expenses on a gross basis, moving the fees and recoveries to the revenue section. As part of the research for this project, other provinces will be contacted with enquiries on how they prepare, vote and monitor their budget figures. The key users of the Estimates will also be consulted. Those options will be evaluated and revised disclosures will be assessed for the 2006-07 Estimates.

- On consolidation, the tangible capital asset (TCA) balances of entities included in the reporting entity are not adjusted to comply with the government's TCA accounting policy requirements for such things as capitalization thresholds, amortization rates and useful life expectancy. Management has indicated that there would be practical challenges in implementing this requirement and it is felt that the costs of doing so would exceed the benefits.

Management's Response:
It is the opinion of management that adjustment to the tangible capital asset balances of entities would generate only limited information at a very high cost. There is a fundamental problem with imposing the thresholds, amortization rates and useful life expectancy of an entity the size of the Province onto the TCA balances of separate, autonomous, unlike, organizations. These entities have selected their own capital asset policy appropriate to their own operations and materiality levels. Imposition of the Province's thresholds, amortization rates and useful life expectancy appears inappropriate. The accounting requirement, alone, would be prohibitive, for a questionable amount of additional information.

- GAAP requires contributed capital assets to be recorded at fair market value. The government's TCA policy requires recording such items at $1. To date this has not been a significant issue because the amount of contributed assets has been limited. If this were to change, it could become a more significant GAAP issue.

Management's Response:
The TCA Policy Review Committee reviewed the accounting treatment for contributed assets. The Committee concluded the accounting treatment in the TCA Policy is appropriate. The occurrence of gifts to the Crown is infrequent in nature, and the value of gifts to date has been insignificant. As a result, the impact of contributed assets on the financial statements is

immaterial. If this were to change, management would revisit the accounting treatment.

- A number of smaller crown entities and government partnership arrangements are not being fully and appropriately accounted for in the consolidated financial statements. The impact of this is an understatement of net assets and an overstatement of net direct debt of $24.1 million.

  Management's Response:
  The Department of Finance's Government Accounting division annually reviews all smaller crown entities and government partnership arrangements and makes changes that are considered appropriate and material to the Province's financial statements. This approach is consistent with prior years. A detailed cost benefit analysis is performed and a reasonable decision made with respect to which smaller entities will not be consolidated. This analysis is available for review by the Office of the Auditor General with respect to the decision not to consolidate.

- Derivative transactions are recorded between the consolidated fund, the sinking fund, and the public debt retirement fund of the Province. These are inter-entity transactions which should be eliminated. The impact of this is an overstatement of the current surplus of $7.4 million, an understatement of liabilities of $13.2 million, and an understatement of opening net direct debt of $5.8 million.

  Management's Response:
  The Department is comfortable that the accounting, presentation and disclosure of all financial instruments is fairly represented in the audited financial statements.

The first three bullets above exist because of the structure of the budget. We understand that a group has been formed to review the usefulness and format of the content of the province's financial reports, including the budget, to ensure they meet the requirements of the users. We believe this is a valuable exercise but would like to point out that any recommendations from this group should be GAAP compliant.

We recommend steps be taken to ensure fuller GAAP compliance by the Province, especially with regard to disclosing GAAP compliant budget information in the financial statements.

Management's Response:
The Department has made great strides in adopting and enhancing its GAAP compliance over the last 6 years. The group formed to review the Public Accounts and Estimates reports aims to ensure that the information is useful to readers. The Department of Finance has documented that one of this group's standard terms of reference is that all changes must be GAAP compliant. Also, Government Accounting's Manager of Financial Reporting has been assigned to this very important review project for quality control in this area of expertise.

GAAP related accounting standards and pronouncements will continue to evolve. There are some new and in process PSAB pronouncements that will have an impact on the government's future reporting of the Province's financial performance and financial condition. In order to ensure any GAAP adjustments necessary for government's financial planning, budgeting, and reporting are implemented on a timely and effective basis, Department of Finance needs to continue its efforts to monitor new and emerging accounting standards and pronouncements. In this regard, the following are some examples of those areas where PSAB has or is developing new or revised pronouncements:

- liabilities, contingent liabilities, and contractual obligations;
- generally accepted accounting principles;
- measurement uncertainty;
- government transfers; and
- financial instruments.

Further, government should disclose the nature and impact of required or planned accounting changes as soon as practical, ideally no later than during the presentation of the budget for the fiscal year in which the changes will take effect.

Management's Response:
The Department of Finance closely monitors the evolution of accounting standards and pronouncements as part of its on-going activities and ensures changes are incorporated in the budget process. Responses are often prepared for CICA/PSAB Exposure Drafts and other CICA Handbook-related documents that are offered for comment. Representatives from Finance as well as Treasury and Policy Board have taken an active role in CICA Study Groups and Task Forces. As well, Government Accounting prepares a thorough review and analysis of the PSAB Handbook.

Systems and controls – As part of our audit, internal controls were reviewed only to the extent necessary, under Canadian generally accepted auditing standards, to establish a basis for determining the audit coverage necessary to express an opinion on the Province's consolidated financial statements. The audit work was not designed to determine whether internal controls are adequate for management's purposes and will not necessarily disclose all conditions requiring attention by management.

While conducting the financial statement audit, areas were identified where internal controls could be strengthened or operating improvements achieved. Certain matters identified during the current year have implications which warrant management's attention. Appendix 1, attached on pages 13 - 22, includes the more significant of these matters. They have been discussed with your staff. As part of the audit of the Province's March 31, 2006 consolidated financial statements, we will follow up on these matters to determine the status of actions taken or planned.

Further, as it relates to the internal controls of the entities consolidated in the Province's financial statement reporting entity, reliance has been placed on the audit work of public accounting firms appointed to report on the financial statements of those entities. There is a chapter in the December 2005 Report of the Auditor General which will include information on selected weaknesses in internal controls which were reported to those entities by their auditors.

Management judgments and accounting estimates – Government's preparation of the Province's consolidated financial statements requires the use of significant accounting estimates, certain of which are particularly sensitive to future actual results differing from government's assumptions upon which the accounting estimates are based. For example, significant accounting estimates are used in determining accruals for income taxes, sales taxes, restructuring costs, and net retirement benefit obligations or costs.

At the conclusion of this year's audit there were no significant outstanding concerns with the estimated accounting balances used in preparing the March 31, 2005 consolidated financial statements.

Adjustments made to the financial statements – During the audit of the March 31, 2005 CFSs a number of accounting, disclosure and audit issues arose, and were communicated to government staff at various points in the audit process. Some, but not all, of these issues were resolved either by review of additional information provided to us or by adjustments being made to the financial statements. As a result of our audit, there were 18 post trial balance (PTB) entries made which resulted in a net increase in assets of $2.4 million, a net decrease in liabilities of $5.4 million, and a net increase in the surplus of $7.8 million on the financial statements. Included in the PTBs was an adjustment which:

- decreased accounts payable and increased deferred revenue by $104.3 million;
- decreased short-term borrowings and increased unmatured debt by $69.8 million; and
- increased accounts receivable and decreased prepaid expenses by $20.5 million.

There were two adjustments made to the financial statements without a PTB. One increased assets and liabilities by $23.3 million and the other increased loans payable and decreased accounts payable by $120.3 million. There was also a net increase in contractual obligations of $583.3 million as a result of 8 adjustments.

Management's Response:
While the impact of all PTBs was small, we acknowledge that in certain cases there are late entries. In an effort to provide better information within the general ledger, there was an effort made to prepare individual rather than summarized entries. This contributed to an increase in the number of entries posted.

In some cases it is not appropriate to prepare a PTB and the item is better adjusted by reclassification. All items are individually noted on a complete continuity schedule and sent to the OAG on an ongoing basis throughout the audit.

Misstatements in the financial statements – It is my opinion that all but trivial known errors or misstatements identified in the Province's CFSs during the year end accounting or audit processes should be corrected. However, it is not unusual for an entity the size and nature of the Province to have residual issues at the conclusion of its audit. Such issues may be classified as "known" or "possible" depending on the support available.

Any unresolved, unadjusted errors or differences are considered when preparing the auditor's report on whether the statements "present fairly" in accordance with GAAP.

There were known and possible unadjusted errors or differences identified during the audit. Management has represented, and I have concluded that there were none that would, individually or collectively, materially affect the Province's reported financial position, results of operations, changes in net direct debt or cash flows. Appendix 2, attached on pages 23 - 24, includes the more significant of those known errors or differences not adjusted by management which were not already discussed in the "significant accounting policies" section of this letter.

Certain of these issues will have a reversing or carry-forward effect on the Province's March 31, 2006 consolidated financial statements, which we will need to take into account when auditing and reporting on those statements.

Disagreements with management – The "significant accounting policies" section earlier in this letter notes areas where the Province is not fully GAAP compliant and Appendix 2 notes the more significant known errors or differences not adjusted by management.

This year a change was made to each of the discount rates used to estimate pension, retirement and other obligations. We have no concerns with the changes made or the new assumptions used. However, we did have a disagreement with management as to the need to disclose the dollar impact of the assumption changes. GAAP indicates that disclosure of the impact of the changes is desirable as opposed to required. However, it is my opinion that the significance of the impact of the changes warrants disclosure. The result of the change in relation to the two main funded pension plans was to increase debt servicing costs and thus reduce the surplus by $22.7 million. The change also resulted in an increase in the unfunded position of the two plans of $320.9 million. This disagreement was mainly resolved when the impact of the changes, as noted above, on the two main funded pension plans was added to note 7 and referred to in note 2 in the CFSs. However, the impact of the change on the other benefit plans was not determined or disclosed.

Management's Response:

Section 2120.28 of the PSAB Handbook states "Disclosure of the nature and effect on the current period may be desirable for a change in an accounting estimate that is rare or unusual and that may affect the financial results of both current and future periods."

Significant changes were described in appropriate detail in appropriate places. The impact of the rate change was disclosed in detail in the Note 7, "Pension, Retirement and Other Obligations". It was also referred to in Note 2 to the financial statements, "Accounting Changes". It was also disclosed in the analysis of changes in debt servicing costs in the FSDA. It did not have a significant impact in terms of the other analysis formats presented.

Changing a discount rate is not seen as an unusual event that requires extensive disclosure throughout the document. We feel sufficient disclosures were made. The intention is to balance the desire to provide extensive complex information with the need to provide a certain level of understandable information in the Public Accounts.

Difficulties encountered performing audit – There were no major difficulties encountered in performing the audit. There were no limitations placed on the scope of the audit work carried out. The year-end accounting and audit readiness requirements were satisfactorily met. Further, Government Accounting staff efforts to deal with issues identified in a timely manner, contributed to the achievement of the reporting deadline.

Based on the results of the 2003-04 financial statement audit, Finance's Government Accounting Division had agreed to focus additional attention on the contingencies and contractual obligations of departments and the segregation of year-end accrual balances of departments. The Division increased its quality assurance processes on the information provided by departments and agencies, in order to reduce the risk of errors in the draft financial statements and improve the efficiency of the year-end accounting processes. There was a noted improvement in these two areas; however, further improvements are required on the contingencies and contractual obligations as noted in Appendix 1.

Management Response:
The Department of Finance was very pleased with the progress made in the areas of contingencies and contractual obligations. Further improvement should be noted for the 2005-06 fiscal year as all parties involved become more comfortable interpreting these relatively new Handbook sections. Interpretation requires professional judgment and discussions regarding how standards apply to various circumstances. This is especially true with an entity the size of the Province; with the diverse activities and service offerings. Government Accounting will continue working with the departments, agencies and will also work with the Office of the Auditor General to try to achieve consistent application and interpretation of these sections.

There were a few significant accounting issues which had to be dealt with late in the audit process. However, we were able to satisfactorily resolve these issues and provide the audit report by the required date.

We encountered delays in completing the audit work on restructuring costs. Support for the salaries used to estimate accruals recorded was not available for a sample item selected from two departments. The support had to be recreated. There is a need to communicate to applicable staff, the requirement to maintain adequate support for postings made to SAP.

Management Response:
The requested support for the salaries used to estimate accruals is payroll information and must be carefully safeguarded. In completing the audit work, sufficient evidence and relevant data was recreated. We acknowledge that some additional payroll information should be retained at Treasury and Policy Board to provide a more efficient means of completing the audit work.

Financial Statement Discussion and Analysis (FSDA) – According to PSAB's Statement of Recommended Practices, the purpose of the FSDA is to "*expand on and explain information contained in summary financial statements, making them more useful by extending the understanding of the information they report beyond those who*

possess technical expertise." We have read, but not audited, the information in the FSDA section of Volume 1 of the March 31, 2005 Public Accounts (i.e., pages 9 – 43). Where applicable, totals have been reconciled to the consolidated financial statements upon which I have reported.

We acknowledge that changes have been made to the content of the FSDA this year based upon new guidelines issued by PSAB. We encourage government to continue to improve the content of the FSDA. It may be beneficial to review what other jurisdictions include in their FSDA to aid in this process. The following are some examples of improvements which will enhance the FSDA's effectiveness:

- Due to the lack of full consolidated budget information, the FSDA includes a lot of focus on consolidated fund level information as opposed to the audited consolidated financial statement information. This focus may impair clarity and understanding of the consolidated financial performance and condition of the Province;

  Management's Response:

  Management believes the FSDA adds clarity and understanding for the reader of the Public Accounts. The first section of the FSDA provides analysis of the consolidated results to help readers understand the overall financial results for the province. The content of this section is clearly explained, with the required reference to the consolidated financial statements.

  The explanations regarding the Consolidated Fund are provided as an accountability function for actuals versus the budget. Users look to the Public Accounts for this type of analysis on the official final financial results. It is highlighted in headings that the information is based on the Consolidated Fund only.

- Explanations for significant variances between current year's actual results and the prior year's actual results should be included;

  Management's Response:
  Management feels the levels of reporting are adequate and tailored to the readers' needs. Year over year variances have been provided in the FSDA analysis of the consolidated financial statements so readers can understand what has changed. The Consolidated Fund analysis is shown only as budget versus actual because that is the accountability focus of reporting on the Consolidated Fund.

- In 2004-05 a change was made to the discount rates used to estimate pension, retirement and other obligations. When there is a change in an assumption used to estimate a financial statement balance and the impact of the change is significant, the full impact of that change should be discussed throughout the FSDA where balances affected are disclosed;

  Management's Response:
  Significant changes were described in appropriate details in appropriate places. The impact of the rate change was disclosed in detail in the Note

7 to the financial statements, "Pension, Retirement and Other Obligations". It was referred to in Note 2 to the financial statements, "Accounting Changes". It was also disclosed in the analysis of changes in debt servicing costs in the FSDA. It did not have a significant impact in terms of the other analysis formats presented.

Changing a discount rate is not seen as an unusual event that requires extensive disclosure throughout the document. The objective is to balance the desire to provide extensive complex information with the need to provide a certain level of understandable information in the Public Accounts.

- The risk section could be expanded to include more information on risks associated with debt and other treasury management. In addition to identification of the risks of government, a discussion of the government's risk management policies and strategies, including the exposure limits set by the Province, should be provided. It may also be useful to illustrate the sensitivity that uncontrollable factors can have on the financial performance of the province; and

  Management's Response:
  We will consider this for future FSDA. However, the objective is to balance the desire to provide extensive complex information with the need to provide a certain level of understandable information in the Public Accounts. Management believes this level of information is already disclosed through other avenues and sees this as a duplication that may be confusing to the reader.

- In the initial draft of the variance analysis section for revenues and expenses, the headings included an indication of whether the area was over/under budget and by what amount. The subsequent removal of this information impairs the usefulness and understanding of the information.

  Management's Response:
  The information was provided for all departments in the table preceding the explanations. It was thought that this was a concise way to show readers all results in one area. Removing the notations from the subsequent departmental headings was merely a presentation style issue, not a deviation from GAAP.

We encourage Government Accounting staff to continue in their efforts to further improve upon the FSDA.

Additional Appropriations – Based upon a review of information included on page 31 of Volume 1 of the March 31, 2005 Public Accounts, additional appropriations of $159.4 million require Order in Council approval. According to Section 28 of the Provincial Finance Act, this approval is required within 90 days of the release of the March 31, 2005 Public Accounts. At the time this letter was written, the required Order in Council approval was outstanding.

Management's Response:
This item will be processed within the allowed timeframe.

Other - As well, during the course of this year's audit, we did not encounter any:

- irregularities which suggested any incidences of fraud on the part of any employee of the government;
- illegal acts; or
- related party transactions which were other than in the normal course of operations and which involve significant judgments by management concerning measurement or disclosure.

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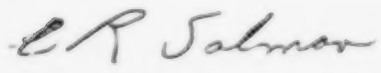
The cooperation and assistance provided during this year's audit by Finance and other government management and staff is acknowledged and appreciated, especially that of Finance's Government Accounting staff.

If you have any questions or wish to meet to discuss this report or any other matters, please do not hesitate to contact me.

Yours truly,



E. Roy Salmon, FCA
Auditor General

cc President and Members of the Executive Council
Vicki Harnish, Deputy Minister of Finance
Byron Rafuse, CMA, Controller

APPENDIX 1

CONSOLIDATED FINANCIAL STATEMENT AUDIT
MARCH 31, 2005
AUDIT OBSERVATIONS

Observation

1 Financial Management and Accounting Policies

A key control to ensuring reliable financial reporting and the safeguarding of resources is the existence of documented policies and the effective communication of those policies. In February 2003, updated government management manuals were released on the Treasury and Policy Board website. These manuals include some, but not all, relevant policies. Government Accounting staff have acknowledged the need and intention to further develop and enhance government's financial management and accounting policies. However, there have been no new policies added to the manuals since they were released. We understand that there are some draft policies developed which are awaiting approval.

We recommend a defined plan and schedule be developed to ensure the government management manuals are updated, to include all relevant financial and accounting policies, in a timely manner.

We will continue to monitor progress in this area.

Management Response:
This continues to be a priority. During 2004/05 a number of new policies have been drafted as well as amendments made to existing sections to bring them up to date. These changes are ready for approval and additional sections will be updated throughout 2005/06 and beyond.

2 Responsibility for Internal Control

Roles and responsibilities concerning internal controls are delegated throughout government. While the Provincial Finance Act includes general references to the roles and responsibilities of the Minister and Deputy Minister in this regard, additional guidance needs to be developed, and effectively communicated on a more comprehensive basis. This would include the roles and responsibilities of departmental and crown entity governing bodies and senior management in the design, implementation, operation and maintenance of internal controls.

We recommend the roles and responsibilities for internal control within government be clearly documented and effectively communicated.

Management Response:
Management believes that throughout government the roles and responsibilities for internal controls are understood, but acknowledge that this understanding is not clearly documented. We agree that the roles and responsibilities, including control procedures, be documented as a risk management strategy.

Observation

3 Risk Management

One of the components of internal control is risk assessment and the processes established to respond to risks identified in order to ensure government objectives are achieved. This would include the risk assessment and processes to ensure the integrity of the financial statements. As part of our knowledge gathering in planning for the audit of the financial statements, we requested that the Deputy Minister and senior financial executive of each department and agency of government complete a management inquiry questionnaire. One question included was *"Has the risk of a material misstatement of the financial statements due to fraud been assessed?"* The common answer to that question was no. There should be an ongoing process in place to identify the risks to the integrity of the financial statements and ensure the exposure to such risks is minimized. This process should be documented. This is an important component of an effective internal control system.

We recommend an ongoing process be established to identify the risks to the integrity of the financial statements and ensure the exposure to such risks is minimized. This process should be documented.

Management Response:
Management agrees that a risk assessment and the development of a risk mitigation strategy is a key component of internal control. In regard to the integrity of the financial statements, the risk assessment would not be limited to a possible misstatement due to fraud, but rather an overall assessment. We will be working with Corporate Internal Audit to develop and document this process.

4 Internal Audit Function

Government's internal audit function is centralized within the Department of Finance. The existence of an effective internal audit function in government is an important mechanism to assist management in monitoring its discharge of responsibilities for the use and control of public resources.

There have been a number of organizational changes within internal audit since it was centralized which have been detrimental to its effective functioning. As a result, management established a committee in 2004-05 to review the mandate, governance and organizational structure of the internal audit function to ensure it is effective. The recommendations of this committee were approved in principal in February 2005. Based on the recommendations, the role of internal audit in government will be changing to focus more on business risks; including a risk based approach to audit planning and auditing and assessing whether government's risk identification and mitigation practices are adequate.

We acknowledge the efforts that have been made to ensure the effective functioning of internal audit within government and encourage continued commitment in this regard.

Observation

We understand that with this changing focus of internal audit, there may be less internal audit resources available to departmental management for compliance testing to ensure the effective operation of internal controls. With the internal audit resource availability for compliance audits changing, it is important that government internal controls are being dealt with effectively.

We recommend government and departments ensure their roles and responsibilities for internal control are being dealt with effectively and where appropriate, subject to effective coverage by internal audit or other audit resources.

Management response:
Based on the Report on the Review of Internal Audit, Internal Audit and management have commenced the implementation of the recommendations contained in the report.

The changes reflect best practice as advocated in the Professional Practice Framework for the Institute of Internal Auditors.

The primary role for Internal Audit, as outlined in the Internal Audit Charter, and approved by the Audit Committee, is to determine whether the Province's network of risk management, control, and governance processes, as designed and represented by management, is adequate and functioning in a manner that ensures: that resources are acquired economically, used efficiently and adequately protected; that programs, plans, and objectives are achieved; that risks are appropriately identified and managed; that significant financial, managerial, and operating information is accurate, reliable and timely; and that a strong governance and control environment is promoted. This role meets the standards for the Institute for Internal Auditors and reflects best practice.

There is no change in role for ensuring compliance with policies and procedures, which are themselves internal controls. The outcomes of the risk assessment will determine the allocation of the audit resources and audit projects; therefore, if compliance is not identified as the area of highest risk in any given year, reliance will be placed on the internal controls management has implemented.

5 Investment, Liability Management and Treasury Services and Capital Markets Administration Divisions

An audit concerning the governance and control framework around the operations of the Investment, Liability Management and Treasury Services and Capital Markets Administration divisions was completed for Finance by a private sector firm during 2004-05. A final report was released publicly in December 2004 and identified significant control weaknesses which resulted in a denial of opinion.

It should be noted that certain of the more significant issues identified as a result of this audit are consistent with concerns raised by our Office in the past.

From a financial statement audit perspective, we have assessed this area as high risk and as such have not placed any reliance on internal controls when doing testing for the

financial statement audit.

We have not assessed the action taken on the recommendations of the report. Management has indicated that all major aspects of the audit have been implemented.

We recommend a follow up audit be conducted by the firm or another private sector firm with the expertise necessary to effectively follow up on the weaknesses that were problematic in terms of the audit opinion. Until an unqualified opinion is received, the denial of opinion will have to be disclosed in government's SEC and any other financial filings.

We recommend a follow up audit be conducted concerning the governance and control framework of the operations of the Investment, Liability Management and Treasury Services and Capital Markets Administration Divisions. This audit should be completed by the public sector firm who completed the 2004-05 audit or another public sector firm who has the expertise necessary to effectively follow up on the weaknesses that were problematic in terms of the audit opinion resulting from that audit.

Management's Response:

Senior management of the Department of Finance fully intend to have a follow up audit completed to ensure that the actions taken adequately address the issues identified in the audit report. This audit will not, however, take place within this fiscal year. Management would like to have all policies not only approved, but also properly implemented, and in operation for a period of time before such an audit is undertaken. This will ensure that the follow up audit will be better able to determine if the actions taken have addressed the issues.

The original audit was CIA's (Corporate Internal Audit), which they chose to outsource. The responsibility for the follow up audit would also rest with CIA. CIA will decide whether they will conduct this audit work themselves, or go through another out-source contract. The decision to outsource or not will depend on the availability of appropriate internal resources.

6 Service Auditor's Report for the Centralized SAP Infrastructure

During 2004-05, government contracted for an annual service auditor review of Finance's SAP Customer Competency Centre (CCC). This included a service auditor report on controls for the centralized SAP infrastructure and support functions performed by the CCC for government and for a number of public sector entities. The first service auditor report contained a reservation of opinion for eight control procedures in five of nine areas examined as detailed in Chapter 3 of the June 2005 Report of the Auditor General (see paragraph 3.16 and 3.17 of that report). This first report provided an opinion as at a specific point in time (November 15, 2004). The contractual arrangement with the service auditor calls for further audits. The weaknesses identified in the first report should be addressed so that an unqualified opinion may be provided in the future.

Observation

It should be noted that certain of the more significant issues identified as a result of this audit are consistent with concerns raised by our Office in the past.

With regard to the March 31, 2005 audit of the Province's CFSs, the results of the service auditor report were considered in the planned audit coverage.

To date, this has been the only service auditor report issued. Management has indicated that they plan to have the next audit begin in February 2006 covering the period April 1, 2005 to March 31, 2006. We encourage the Department to implement its plan in this regard such that it will be available for use in the March 31, 2006 financial statement audit of the province and those public sector entities that use the CCC.

We recommend steps be taken to ensure the weaknesses identified in the first service auditor report for the centralized SAP infrastructure are addressed so that an unqualified opinion may be provided. As well, the next report should be completed and issued so it is available for use in the March 31, 2006 financial statement audit of the province and entities that use the SAP Customer Competency Centre.

Management Response:
The first service auditor review of the Core Competency Centre was a valuable learning experience for the Department of Finance. Although the review contained a reservation of opinion on eight control procedures, it did focus attention on service level agreements for support functions. The Department is committed to addressing all identified issues, however, there will be limitations to our ability to respond to all procedures as ownership of some control procedures rest with outside entities. The Department will ensure that the next audit is available for the March 31, 2006 financial audit of the Province and for those entities that use the Core Competency Centre.

7 Service Nova Scotia and Municipal Relations (SNSMR) Suspected Fraud

During 2004-05, a suspected fraud was discovered in the Business Registration Unit section of the Registry and Information Management Services division of SNSMR. There was a misappropriation of funds totalling approximately $360,000 over approximately 7.5 years. With regard to the March 31, 2005 audit of the Province's CFSs, the occurrence of this suspected fraud has been considered in the planned audit coverage.

As a result of the suspected fraud, a private sector firm was engaged to complete a review of controls around cash receipts and refunds in the Business Registration Unit and report recommendations to improve controls. This report was issued in May 2005 and included a number of recommendations for improvement. An internal committee was established to assess the feasibility and priority of implementing the recommendations. We encourage management to address these recommendations in a timely manner.

Management Response:
Senior management at Service Nova Scotia and Municipal Relations advise that all recommendations of the review of controls at the Business Registration Unit will be implemented in a timely manner.

Observation

8 Contingencies and Contractual Obligations

Last year we reported a number of issues around the draft contingencies and contractual obligations note. This year we noted improvements in this area but still have concerns with some of the findings identified. The significant issues arose in the Departments of Health and Education. There may be a need for further training of applicable staff within these departments to ensure they have a complete understanding of what a contractual obligation is.

The following are the more significant errors noted during our audit.

- Under a memorandum of understanding signed July 12, 2004, specific funding amounts for universities have been agreed to for the period 2004-05 to 2007-08. The amount of the contractual obligation initially identified by the Department of Education only considered the "additional funding". It should have included the total commitment under the agreement. This resulted in an understatement of contractual obligations of $643.1 million.

- The Department of Education noted a contractual obligation to Dalhousie University based upon a letter dated in 2002 and signed by the Minister at that time. It was determined that the assistance promised in that letter could be overturned by the current Minister and therefore is not a contractual obligation. This resulted in an overstatement of contractual obligations of $21.0 million.

- The Department of Health had listed contractual obligations for two contracts which were still in negotiation at year end and not signed until after year end. This resulted in an overstatement of contractual obligations by $39.3 million.

All items identified were adjusted except for one which was less than $2 million. The net impact on the contractual obligations balance, for adjustments made, was an increase in contractual obligations of $583.3 million.

Management Response:

Management is very pleased with the improvements in the reporting of Contingencies and Contractual Obligations for fiscal 2005. While there were a few significant changes to the list as a result of the audit, Government Accounting has discussed the issues with the respective departments. The process was beneficial to all involved and Government Accounting understands why the items had been included or excluded initially and the respective Departments understand the rationale for the subsequent change.

It is important to note that with new Handbook sections and related standards there is judgement and interpretation required. Government Accounting invested a significant amount of time presenting the changes and updating the reporting packages. To work toward continual improvement Government Accounting has proposed reviewing the interpretation of the sections with the Office of the Auditor General during 2006 to limit differences in interpretation.

Observation

9 Environmental Contingencies

There is a new PSAB standard concerning contingent liabilities which is effective for 2005-06. According to the standard the following information should be disclosed in the notes, unless its occurrence is unlikely:

"(a) the nature;
(b) the extent, except in those cases where the extent cannot be measured or disclosure of the extent would have an adverse effect on the outcome;
(c) the reason(s) for any non-disclosure of the extent; and
(d) when an estimate of the amount has been made, the basis for that estimate."

Contingent liabilities include environmental contingencies. There are various provincially owned sites throughout the Province which are considered environmental or contaminated sites. However, efforts are not necessarily made to determine or estimate the costs of remediation for a site once it is known. There are no documented policies and procedures for identifying, evaluating, and accounting for environmental contingencies.

We recommend documented policies and procedures for identifying, evaluating, and accounting for environmental contingencies be developed including the need to be proactive in identifying environmental sites and estimating the remediation costs. The accounting policy should be in accordance with GAAP.

Management Response:
The Province is proactive in identifying environmental sites and taking actions to contain further environmental damage or contamination. The Department of Transportation and Public Works (TPW) maintains a list of sites with environmental concerns. TPW assesses each site to determine the extent of the issue and completes the necessary work. Not all sites require extensive remediation; many sites can be contained until such time as the Province determines the eventual use for the building or piece of land. The use of property will often times impact the extent of remediation (ie - industrial property versus park land). While a documented policy may not currently exist, Government Accounting and the Department of Transportation and Public Works work closely together to ensure the accounting treatment is in accordance with GAAP.

10 Restructuring Cost Budget and Forecast

As part of our audit work on restructuring costs, we obtained a variance analysis between the 2004-05 budget and the 2004-05 actual costs in the consolidated financial statements. The workforce adjustment cost centre in this appropriation had a budget of $4.0 million and actual costs of $.2 million, a reduction in actual costs of $3.8 million. The explanation provided for this variance was that this budget is a contingency to an extent. It is known that some funds will be spent in this area but not what amount. As a result, the budget is kept at approximately $4 million.

As well, the business process reengineering cost centre had a budget of $5.1 million and

Observation

actual costs of $2.4 million, a reduction in actual costs of $2.7 million. The explanation provided for this variance was that staff do not know how many initiatives will occur under this cost centre during the year. For the 2004-05 budget, there were known initiatives of $1.5 million. It was unknown what amount of the remaining $3.6 million would be spent.

As part of our audit work, we also obtained a variance analysis between the 2004-05 latest forecast, included in the 2005-06 Budget documents, and the 2004-05 actual costs in the consolidated financial statements. There were three cost centres within this appropriation which had significant variances - work force adjustments; business process reengineering; and human resource strategy. The total April 2005 forecast for these cost centres was $17.75 million while the actual costs were $3.18 million, a total reduction in actual costs of $14.57 million. The explanation provided for this variance was that there is uncertainty involved in the forecasting process and as a result it is typical to try to ensure that the restructuring cost appropriation contains a contingency to offset this uncertainty.

When forecasting information, there can be uncertainties involved and contingencies used. When such is the case, the contingencies should be clearly disclosed in the forecasting document. As well, there is a need to have clearly defined policies and procedures concerning the use of contingencies in the forecast including when to use them, the approach used to determine the amount, and the review and approval process for their use and the amounts used.

We recommend that policies and procedures concerning the use of contingencies in the Province's budgets and forecasts be clearly defined and communicated and when contingencies are used they be clearly disclosed in the applicable document.

Management response:
In an entity the size and complexity of the Province, it can be difficult to precisely estimate and forecast all expenditures and revenues. The inclusion of a contingency is not considered unreasonable given the uncertainties involved in the budget, forecast and consolidated processes.

11 Special Warrants

According to Section 29 of the Provincial Finance Act, expenses which have not been provided for by the Legislature and are urgently and immediately required for the public good, must be approved by Order in Council (OIC) as special warrants.

There were a number of strategic initiatives announced in 2004-05, none of which were approved by OIC. Some of these initiatives may possibly meet the criteria of a special warrant and thus should have been approved by OIC.

There is a need to obtain clarity on what constitutes a special warrant versus an additional appropriation. Management has indicated that a legal review of Section 29 of the Provincial Finance Act will be obtained to provide this clarity prior to the implementation of any similar strategic initiatives.

Observation

Management Response:
Management agrees that clarity is needed on the use of special warrants. A review will ensure that all legislative authorization as required under the Provincial Finance Act is obtained. This review is currently underway and the outcome will be incorporated in the expenditure approval process.

12 Approval of Cheque Requisitions

During our testing of transactions at the Office of Economic Development, we found three cheque requisitions which were approved by the Minister or Acting Minister. The signature was not on the original cheque requisition. It was on a sticker which was attached to the cheque requisition. In order for adequate controls to exist, original documents should be signed for approvals. Staff have indicated that the cheque requisition form has been revised to provide a space for the Minister's signature and that the stickers are not used anymore.

Management response:
All cheque requisitions now have an original signature from the Minister. The Manager has met with accounting staff to ensure all future requisitions are signed prior to processing; and written follow-up has been communicated to OED staff. As well, staff is reviewing all entries for 2004-05 and the current fiscal year, 2005-06, to ensure all entries bear original signatures.

13 Post Trial Balance Entries and Unadjusted Differences

Last year there were a large number of post trial balance (PTB) entries made. The number has increased this year. This includes entries identified by departmental staff as well as those resulting from audit work. There were also a number of unadjusted entries, for various reasons, at the end of the audit. There is a need to analyze these items to determine if certain matters can be dealt with earlier in the year-end accounting process in future years.

Related to this is the fact that there were 12 cut off errors identified in 7 departments, some of which were corrected. These errors should be examined to determine their cause so this type of error will be prevented in the future.

We recommend that an analysis be completed of PTBs and unadjusted differences to determine if certain matters can be dealt with earlier in the year end accounting process in future years.

Observation

Management response:

To provide better identification of all amounts in the general ledger, a conscious effort was made to individually record entries on separate PTBs. This contributed to the increased number.

We acknowledge the identification of cut-off areas and will address this in preparing for the 2005-06 year end audit. We will be reviewing this situation with the financial executives and managers as part of this work.

APPENDIX 2

CONSOLIDATED FINANCIAL STATEMENT AUDIT
MARCH 31, 2005
EXAMPLES OF IDENTIFIED ISSUES – UNADJUSTED

Known Misstatements
1. Finance The Provincial Child Tax Benefit (CTB) is paid to recipients by the federal government and then recovered from the Province in the subsequent month. The CTB amount recovered by the federal government in April 2005 was $2.1 million. This amount should be a payable to the federal government at March 31, 2005. There is a net payable balance of $3.3 million in the general ledger so payables are overstated by $1.2 million and net direct debt is overstated by the same amount. ***Management Response:*** *The amount withheld at the beginning of the year in April 2004 also needs to be considered when calculating any misstatement. The amount was $2,248,105.57, which means that the misstatement caused by the 1-month time lag is $150,956.57, which is considered immaterial to adjust.*
2. Finance During consolidation, we identified accounting changes in consolidated entities which were recorded prospectively, i.e., in the 2004-05 year versus retroactively. As a result, the surplus and opening net direct debt are overstated by $2.1 million. ***Management Response:*** *Noted*
3. Restructuring Costs There is an accrual for a legal settlement which is understated based upon the amount offered as a settlement for some claimants. This results in an understatement of liabilities and expenses of $1.8 million. ***Management's Response:*** *This item was under ongoing negotiation during the year-end process. The difference quoted above was not considered material.*
4. Service Nova Scotia and Municipal Relations There is a liability account balance which is actually revenue generated from the sale of maps and related products which have been internally restricted to fund contracts for geographic database development and mapping. This results in an overstatement of accounts payable and an overstatement of net direct debt of $3.6 million.

Management's Response:

Revenue is now being recorded and the deferred revenue account was not increased during 2005/06. Although the balance of the deferred revenue account has not yet been reduced, there was significant planning during 04/05 and the balance will be drawn down in 2005/06 and 2006/07. The $1.5 - 2M of the deferred revenue balance will be recognized in 05/06.

5. Transportation and Public Works

There was a liability and land of $1.3 million recorded in 2002-03 on the speculation that a highway would be constructed. The provision relates to the future purchase of land to construct the highway. At March 31, 2005 there is no liability and the Province does not own the land. No event has occurred which obligates the Province to buy the land. This results in an overstatement of liabilities and tangible capital assets.

Management's Response

The accrued liability and land amount of $1,300,000 was established in 2002/03, and it remains the best available estimate. Preserving a corridor for Highway 113 is a priority of TPW. Full negotiation is expected by February 2006.